Can Sri Lanka Join Asian Supply Chains?

Guest Article by Ganeshan Wignaraja

President Trump's pledge to put America first during a global trade slowdown has sparked worries that the era of export-led growth has ended. Trade in Asia and globally has slowed since the 2008 global financial crisis but it is not the end of export-led growth. The real issue, however, is whether Sri Lanka can follow East Asia's success in global supply chains amid slower trade growth and a likely rise in protectionism.

Global supply chains refer to the geographical location of stages of production (design, production, marketing, and service activities) in a cost-effective manner and linked by trade in intermediate inputs and final goods. For instance, the Toyota Prius—a hybrid electric mid-size hatchback car—for the US market was designed in Japan and is largely assembled there, but some parts and components are made in Southeast Asia and China. Supply chains exist in a wide range of manufacturing and services activities.

East Asia's shift from a poor, less developed agricultural periphery to a wealthy global factory over the last half a century is an economic miracle. The extent of the region's participation in global supply chains is significantly greater than elsewhere, and has spurred East Asia's global rise to the coveted "Factory Asia" league with middle-income status for many economies. In 2015, the developing economies in East Asia accounted for 34% of global supply chain trade with China making up 15% and Southeast Asia for 7%. This compares with 34% for the European Union, 10% for the United States and 5% for Japan.

However, South Asia is a relatively small player. India accounts for 1.7% of global supply chain trade and the rest of South Asia including Sri Lanka for 0.13%. Structural transformation and rising wages in China has encouraged an outward shift of labor-intensive segments of supply chains ranging from clothing to electronics. Sri Lanka has the potential to attract such supply chains from China. It is strategically located on the way to Europe, offers low wages with reasonable labour productivity and has a dynamic clothing industry. Close proximity to the large Indian market, which is a magnet for Chinese outward investment, is another advantage.

Smart business strategies and market-friendly national policies have supported East Asia's achievement in supply chains.[1] Being a big firm naturally creates advantages to participating in supply chains due to a larger scale of production, better access to technology from abroad, and the ability to spend more on marketing. It is crucial for small

[1] See G. Wignaraja (2016 edited), *Production Networks and Enterprises in East Asia*, Springer.

and medium-sized enterprises (SMEs) to work with large firms. Hence, smart business strategies, such as mergers, acquisitions, and forming business alliances with multinationals or large local business houses are all rational approaches; as is investing in domestic technological capabilities to achieve international standards of price, quality and delivery.

East Asia's experience suggests that nimble SMEs can also join supply chains by locating to industrial clusters and reap the benefits of interdependence such as co-financing a training center or a technical consultant to upgrade skills. Business associations can facilitate clustering by mitigating trust deficits to cooperation among SMEs, and by coordinating collective actions for cluster formation. For instance, major industrial clusters are visible in Viet Nam near Ha Noi and Ho Chi Minh City, where large firms are surrounded by thousands of SME suppliers and subcontractors making garments, agricultural machinery and electronics goods.

Turning to national policies in East Asia, modern cost-competitive infrastructure is crucial for supply chains. This means investing in world-class ports, roads to ports, logistics, and electricity supply and information technology infrastructure. Maintaining open trade and investment regimes which encourage investment and transmit price signals to business are likewise important, as well as sound financial systems which emphasize competition among commercial banks and financial inclusion. High-quality, affordable technical and marketing support services and investing in education to develop skilled labor both help SMES join supply chains.

More controversial is the use of industrial policies in East Asia to target credit and subsidies to particular sectors or firms. Some oft-cited examples of failures include Korea's heavy and chemical industry push, Malaysia's national car project (the Proton) and China's home-grown 3G mobile technology TD-SCDMA. More research is needed on good practices, as there is a high risk of government failure and cronyism associated with industrial policies.

Joining supply chains will boost industrialization, jobs and incomes in Sri Lanka. There is no one-size-fits-all approach for Sri Lankan firms to join supply chains. Smart business strategies, facilitating business associations and market-friendly policies are all useful ingredients, while business and government collaboration is essential to tailor these ingredients to national circumstances.

Ganeshan Wignaraja is Advisor in the Economic Research and Regional Cooperation Department of the Asian Development Bank (ADB). The views expressed here are solely the author's own and do not represent the position of the ADB. This is a guest article for the Ceylon Chamber of Commerce 'Trade Intelligence for the Private Sector' (TIPS) initiative that helps our member businesses be up-to-date on new developments in international trade. For more on the subject of this article, refer Production Networks and Enterprises in East Asia an edited volume by G. Wignaraja (2016).